IT 00-1
Tax Type: Income Tax
Issue: 1005 Penalty (Reasonable Cause Issues)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	Docket No. 96-IT-0000
OF THE STATE OF ILLINOIS,	)	FEIN: 00-0000000
v.	)	Tax Years 1989-1990, 1992
"FARNSWORTH, INC.",	)	John E. White,
Taxpayer	)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Helen E. Witt, Kirkland & Ellis, for "Farnsworth, Inc."; Sean Cullinan, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter involves a Notice of Deficiency the Illinois Department of Revenue ("Department") issued to "Farnsworth, Inc." ("Farnsworth" or "taxpayer") regarding tax year ending 12/31/92. It also involves a Notice of Denial ("Denial") the Department issued to taxpayer after considering an amended return "Farnsworth" filed to claim a refund of Illinois income tax and penalties it paid regarding tax years ending 12/31/89 and 12/31/90. Taxpayer protested the NOD and Denial, and requested hearings thereon.

A hearing was held at the Department's Office of Administrative Hearings in Chicago. The only issue remaining unresolved at hearing was the proposed assessment of a penalty pursuant to § 1005 of the Illinois Income Tax Act ("IITA"). I have reviewed the evidence adduced at hearing, and I include in this recommendation findings of fact

and conclusions of law. I recommend that the issue be resolved in favor of the Department.

Findings of Fact:

1. After correcting "Farnsworth's" Illinois income tax returns filed regarding its 1989 and 1990 tax years, the Department issued an NOD that assessed, *inter alia*, § 1005 penalties in the amounts of $4,806 and $3,367, respectively. Taxpayer Ex. 1. Thereafter, "Farnsworth" filed an amended return to claim credit for the amounts of tax and penalty proposed to be assessed regarding those years. *See* Department Ex. 2.

2. The Department issued an NOD regarding "Farnsworth"'s 1992 tax year in which it proposed to assess a statutory deficiency of $16,083. Department Ex. 1. That deficiency included a § 1005 penalty in the amount of $2,505. *Id.* Although "Farnsworth" has not paid the tax due regarding that NOD, at hearing, it did not contest the correctness of the amount of tax proposed to be assessed. *See* Tr. p. 7 (stipulation of counsel).

3. "Farnsworth" is a "Somewhere" corporation with its headquarters located in (Another State). It is engaged in the manufacture and sale of animal antibiotics and animal feed micronutrients for resale primarily to animal feed producers within the United States. "Farnsworth" has a factory located in "Suburb", Illinois. Department v. "Farnsworth", No. 90-IT-0000, p. 3 (finding of fact #1, citing Tr.

pp. 113-116; Dept. Ex. No. 36) (June 18, 1996)[1] (hereinafter, "1996 Admin. Dec."), *aff'd.*, "Farnsworth" v. Zehnder, No. 96-L-50000, slip op. (Cir. Ct. of Cook Co. Dec. 28, 1998).

4. The major issue for each tax year involved the classification of interest income "Farnsworth" received from its wholly-owned foreign subsidiary, "Lubus, International, Inc." ("Lubus"). *See* Department Ex. 1, p. 3 (on the "Explanation of Adjustments" portion of the NOD the Department issued to taxpayer, the Department wrote, "We changed to business income the interest from miscellaneous sources that were an integral part of your trade or business operations"); Taxpayer's Brief in Support of Its Protest of Section 1005 Penalties ("Taxpayer's Brief"), p. 2.

5. The interest income at issue was realized from "Lubus's" payments of a loan "Farnsworth" made to "Lubus" so "Lubus" could purchase "Pompano", a foreign competitor of "Farnsworth's" former parent. 1996 Admin. Dec., pp. 3-6 (findings of fact related to the structure and organization of "Farnsworth, Miami" (its former parent), "Lubus", and "Pompano" (the foreign competitor acquired by "Lubus"), and describing the financing involved with "Lubus's" acquisition of "Pompano"), 8-15 (conclusions of law).

6. "Lubus's" acquisition of "Pompano" allowed "Farnsworth" to sell its products directly or under license in over 40 countries, but principally in the United States,

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[1] In their respective memoranda, both parties refer to and base their arguments upon facts and/or conclusions set forth in the 1996 Administrative Decision. *See* Taxpayer's Brief in Support of Its Protest of Section 1005 Penalties, p. 2; Department's Response to Taxpayer's Brief in Support of Its Protest of Section 1005 Penalties, p. 2. Therefore, I take administrative notice of those facts and conclusions.

Denmark, Finland, Norway, Sweden, Holland, the Middle East, Nigeria, Malaysia, Thailand and Indonesia. 1996 Admin. Dec. p. 4 (finding of fact #6).

7. Taxpayer introduced no competent evidence to show why it reported the interest income it received from "Lubus's" loan repayments as nonbusiness income on the Illinois combined income tax returns it filed for tax years 1989, 1990 and 1992.

Conclusions of Law:

Section 904(a) of the Illinois Income Tax Act ("IITA") provides:

> (a) Examination of return. As soon as practicable after a return is filed, the Department shall examine it to determine the correct amount of tax. If the Department finds that the amount of tax shown on the return is less than the correct amount, it shall issue a notice of deficiency to the taxpayer which shall set forth the amount of tax and penalties proposed to be assessed. If the Department finds that the tax paid is more than the correct amount, it shall credit or refund the overpayment as provided by Section 909. The findings of the Department under this subsection shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax and penalties due.

35 **ILCS** 5/904(a) (*formerly* Ill. Rev. Stat. ch. 120, ¶ 9-904(a) (1989)). Therefore, the Department established the *prima facie* correctness of its determination that the penalty "sh[ould] be imposed …." (*see* Ill. Rev. Stat. ch. 120, ¶ 10-1005(a) (1989)) when it introduced the NOD and Denial under the certificate of the Director. 35 **ILCS** 5/904(a); Department Exs. 1-2. Thereafter, the burden fell on taxpayer to establish that it acted with ordinary business care and prudence when attempting to determine and timely pay its proper Illinois income tax liability regarding tax years 1989, 1990 and 1992. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295, 421 N.E.2d 236, 238 (1st Dist. 1981); *see also* DuMont Ventilation Co. v. Department of Revenue, 99 Ill. App. 3d 263, 425

N.E.2d 606 (3d Dist. 1981); Kroger v. Department of Revenue, 284 Ill. App. 3d 473, 673 N.E.2d 710, (1st Dist. 1996).

"Farnsworth" underpaid the tax required to be shown due on its 1989, 1990 and 1992 Illinois combined income tax returns because it reported the interest income it received from "Lubus" as non-business income, instead of as business income. Department Ex. 1, p. 3; Taxpayer's Brief, p. 2. The only evidence taxpayer offered at hearing consists of a copy of the NOD the Department issued to it in 1994, and two pages of schedules to that NOD. Taxpayer Ex. 1. That evidence, however, does not tend to show that "Farnsworth" acted with ordinary business care and prudence when attempting to determine and pay its proper Illinois income tax liability for the applicable tax years.

As an exhibit to its brief, "Farnsworth" included a copy of the recommended decision that was adopted by the Director, and issued by the Department, following an administrative hearing held to resolve, *inter alia*, whether taxpayer should be subject to a § 1005 penalty for underpaying its Illinois income tax liabilities for tax years 1983 through 1987. *See* Taxpayer's Brief, Ex. A. Taxpayer argues that the prior agency decision concluded that "Farnsworth" "had a good faith position on its classification of the interest it received from its subsidiary" and, "Farnsworth" claims, it had the same good faith basis for taking the same filing position on the returns filed during the subsequent tax years at issue here. Taxpayer's Brief, pp. 2-3. At the hearing held in this matter, however, "Farnsworth" offered no competent evidence to articulate what the "good-faith basis" for taking that filing position might have been. Nor does the prior agency decision set forth, within the findings of fact, the particular factual bases that

might have supported the alj's conclusion that the penalties proposed to be assessed during those prior years should have been abated. *See* 1996 Admin. Dec., pp. 3-7.

The whole of the prior administrative decision's discussion of the § 1005 penalty was set forth on a single page and provided as follows:

> VI. Section 1005 Penalty
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> Section 1005 of the Illinois Income Tax Act provides that:
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> > ...If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment unless it is shown that such failure is due to reasonable cause. This penalty shall be in addition to any other penalty determined under this Act...
>
> As to the issue of the Section 1005 penalty for the year ended 12/31/87, the auditor proposed the subject penalty for underpayment of tax by taxpayer because it was automatically assessed at that time due to the lack of guidelines as to reasonable cause. (Tr. p. 101).
>
> Under federal case law, "reasonable cause" includes taking a good faith position on a tax return. See I.R.C. Section 6664(c). In general, if there is an honest difference in opinion between the taxpayer and the IRS regarding the correct amount of tax, no penalty is imposed. As a result, no penalty would be imposed due to a deficiency arising from a good faith tax return position with regard to law or facts. [S]ee, Ireland v. Commissioner, [8]9 T.C. 978 (1987); Webble v. Commissioner, 54 T.C.M. 281 (1987)[sic]; Balsamo v. Commissioner, 54 T.C.M. 608 (1987).
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> As to the Section 1005 penalty for 1987, taxpayer's position taken on its return as to the interest income from "Lubus" was due to their belief that their facts were analogous to the facts in Section 100.3010(d)(2)(D) [footnote omitted] of the Department's regulations. Notwithstanding the aforementioned, I do not find that Section 100.3010(d)(2)(D) is on point with the facts of this case. However, taxpayer's position was taken in good faith due to the existence of some of the facts contained in the

> instant case and the regulations. Consequently, taxpayer has offered reasonable cause to abate the Section 1005 penalty for 1987.

Taxpayer's Brief, Ex. A, p. 20.

After reading that part of the decision, the former alj's conclusion appears to have been based on "Farnsworth's" asserted "belief that their facts were analogous to the facts in Section 100.3010(d)(2)(D)[footnote omitted] of the Department's regulations." *Id*. Nowhere within that recommendation, however, is there a citation to competent evidence within the record which shows, for example, that "Farnsworth" took that filing position because an officer, employee or agent of "Farnsworth" actually held that belief. For all this record reveals, "Farnsworth's" claimed "good faith basis" for reporting the interest income as nonbusiness income during the prior audit periods may have been supported by nothing more than "Farnsworth's" mere argument at hearing or in its post-hearing briefs - as was done in this case. *See* Taxpayer's Brief, pp. 2-3.

Moreover, the particular Department rule cited by the alj as being the regulation "Farnsworth" believed supported its filing position has nothing whatever to do with the type of income that was at issue in that prior contested case, and is also at issue in this matter. Subsection (d)(2) of rule 3010, and all of the examples listed under that subsection, describe circumstances under which items of rental income might be reported as either business or nonbusiness income. 86 Ill. Admin. Code § 100.3010(d)(2). Specifically,

§ 100.3010(d)(2)(D) provides:

> d) Items referred to in IITA Section 303 and unspecified items under IITA Section 301(c)(2).
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> * * * *

> 2) Rents from real and tangible personal property. Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the person's trade or business or is attendant thereto and therefore is includable in the property factor under 86 Ill. Adm. Code 100.3350.
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> * * * *
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> Example D: A corporation operates a multistate chain of grocery stores. As an investment, it uses surplus funds to purchase an office building in another state, leasing the entire building to others. The rental is not attendant to, but rather is separate from, the operation of the grocery store trade or business. Therefore, the net rental income is nonbusiness income.

86 Ill. Admin. Code § 100.3010(d)(2)(D).

Income tax rule 3010 has been in effect, and unchanged, since late 1981. *See* 6 Ill. Reg. 579 (eff. December 29, 1981). Thus, that rule was in effect when "Farnsworth" was incorporated in 1983, during the period when "Farnsworth" was planning its loan to "Lubus" for the acquisition of "Pompano", and during each of the tax years at issue. After reading subsection (d)(2) of that rule, I fail to see how any of the examples described therein might have provided any guidance to "Farnsworth", a taxpayer who was, if its argument is to be believed, attempting to make a good faith effort to properly report the interest income it earned from a loan it made to its wholly-owned subsidiary for the purpose of acquiring another company, whose acquisition was designed to assist "Farnsworth's" unitary business.

In contrast, subsection (d)(4) of income tax rule 3010 discusses how items of interest income should be reported on Illinois income tax returns. That patently more applicable subsection provides (and, since 1981, has always provided):

> 4) Interest. Interest income is business income where the intangible with respect to which the interest was

> received, is held or was created in the regular course of the person's trade or business operations or where the purpose for acquiring or holding the intangible is related or attendant to such trade or business operations.

86 Ill. Admin. Code § 100.3010(d)(4). All of the examples in that subsection inform the reader that the interest income being described is business income. 86 Ill. Admin. Code § 100.3010(d)(4)(A)–(E). While none of the examples in subsection (d)(4) describe interest income earned from a corporation's loan to its wholly-owned subsidiary, simply reading subsection (d)(4) would have notified "Farnsworth" that the interest income it received from "Lubus" during the years at issue should have been reported as business income. Here, "the intangible with respect to which the interest was received, [i.e., the receivable created by "Farnsworth's loan to "Lubus"] … was created in the regular course of ["Farnsworth's] trade or business operations [and] … the purpose for acquiring or holding the intangible [wa]s related or attendant to such trade or business operations." 86 Ill. Admin. Code § 100.3010(d)(4); 1996 Admin. Dec., pp. 10-15.

"Farnsworth" argues that it reported the interest income as nonbusiness income on its 1989, 1990 and 1992 Illinois returns for the same reason that it reported it as nonbusiness income on its 1987 return. Taxpayer's Brief, p. 2-3 ("Taxpayer's position on the business income issue for its tax years 1989, 1990 and 1992 years had the same good faith basis as did its position on the issue for its tax year 1987."). The prior administrative decision shows that "Farnsworth" was aware of the particular administrative regulations that details whether specific types of income should be reported as business income or nonbusiness income. 1996 Admin. Dec., p. 20. "Farnsworth" must also be deemed to have known that, as early as 1986, Illinois courts

had recognized the presumption that income must be considered business income unless clearly classifiable as nonbusiness income. National Realty & Investment Co. v. Illinois Department of Revenue, 144 Ill. App. 3d 541, 553, 494 N.E.2d 924, 932 (2d Dist. 1986).

Even if, during the hearing in this matter, "Farnsworth" had offered competent testimony from an "Farnsworth" officer or employee that he or she reported the interest income as nonbusiness income because the witness had sought out and read § 3010(d)(2)(D) of the Department's income tax rules, that testimony would not have helped "Farnsworth" here. The inference to be drawn from such evidence would be that "Farnsworth" knew where to look for guidance, but instead of referring to the part of the agency's regulation that particularly addressed items of income in the form of interest, "Farnsworth" reported the interest income as nonbusiness income based on an example that had nothing to do with the type of income it received. No good faith is evinced where a taxpayer chooses to take a filing position that is not supported by the *applicable* statute or regulation, or by the particular facts and circumstances of the taxpayer's receipt of the income at issue. In that respect, the facts set forth in the federal administrative cases cited within the 1996 administrative decision are distinguishable from the evidence contained in the record in this matter.

For example, in Ireland v. Commissioner, two separate penalties were added to the amount of tax due from two married individuals, who claimed a depreciation deduction for certain real property taxpayers primarily used in the husband's stock brokerage business. Ireland v. Commissioner, 89 T.C. No. 68, 1987 Tax Ct. Rep. (CCH) Dec. 44,314, p. 3820 (Nov. 9, 1987). The tax court addressed the penalties this way:

> The next issue for our decision is whether petitioners are liable for the additions to tax under section

> 6653(a)(1) and (2). Section 6653(a)(1) and (2) provides for the imposition of additions to tax for the underpayment of tax due to negligence or intentional disregard of rules or regulations. Under section 6653(a), negligence is the lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Neely v. Commissioner, 85 T.C. 934, 947 (1985). Petitioner bears the burden of proving that the determination of the additions is erroneous. Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972).
>
> We do not think that the facts in the instant case warrant the imposition of these additions to tax. Petitioners used the Northport property primarily for business purposes. Although the time spent at the Northport property by the family members of the business associates of Thomas appears to be in the nature of a vacation trip, the family members were there because they were accompanying a family member who was there on business. Furthermore, petitioners and their family did not take a vacation at the Northport property or use it as a residence. Although we have held that petitioners are not entitled to depreciate the Northport property, we do not conclude that depreciating the Northport property was due to negligence or intentional disregard of the Commissioner's rules or regulations. Therefore, petitioners are not liable for the additions to tax determined under section 6653(a)(1) and (2).

Ireland v. Commissioner, 1987 Tax Ct. Rep. (CCH) at 3823. In Ireland, the applicable federal treasury regulation had recently been changed, and the new rule disallowed any depreciation deduction for property used, to any extent, for "entertainment." *Id*. at 3821. Here, in contrast, the pertinent administrative regulation had been in effect since 1981, and "Farnsworth" clearly knew about the existence of that regulation. *See* Taxpayer's Brief, p. 2 (*citing* 1996 Admin. Dec., p. 20).

Both Webbe and Balsamo were also cases in which penalties were added to tax assessed against individual taxpayers. Webbe v. Commissioner, 54 T.C.M. (CCH) 608 (Aug. 26, 1987); Balsamo v. Commissioner, 54 T.C.M. (CCH) (Sept. 21, 1987). There were several issues involved in Webbe. In Webbe, the tax court held:

> On the basis of the record, we are satisfied that petitioner's underpayment was not due to negligence or intentional disregard of rules and regulations, but solely to a good faith misunderstanding of the law. Wofford v. Commissioner, 5 T.C. 1152, 1166-1167 (1945). The issues involved were relatively complex, and there could be (and was) an honest difference of opinion. Yelencsics v. Commissioner, 74 T.C. 1513, 1533 (1980); Belz Investment Co. v. Commissioner, 72 T.C. 1209, 1233-1234 (1979), affd. 661 F.2d 76 (6th Cir. 1981). Petitioner on the whole was a credible witness and it is our opinion that his position with respect to the items involved was not untenable. Moreover, petitioner's income tax return was prepared by an accountant and it appears that he relied in whole or in part on the accountant's advice. See Otis v. Commissioner, 73 T.C. 671, 675 (1980). Accordingly, we hold that respondent should not have determined the addition to tax for negligence.

Webbe, 54 T.C.M. at 295. There were no witnesses presented at this hearing, however. The underlying issue in this case, moreover, was not complex. Finally, "Farnsworth's claimed "good faith" basis for taking the filing position here has nothing to do with the facts surrounding the type of income it actually received. In other words, "Farnsworth's claimed justification for reporting the interest income as nonbusiness income *is* untenable.

Balsamo involved a penalty added to the tax assessed against a widow who claimed certain deductions regarding the sale of property that was part of her husband's estate. Balsamo v. Commissioner, 54 T.C.M. (CCH) 608 (Sept. 21, 1987). The Balsamo court held:

> Section 6653(a) provides for an addition to tax if 'any part of the underpayment * * * of any income * * * is due to negligence or intentional disregard of rules or regulations.' Petitioner bears the burden of proving that respondent's addition to tax of $402.07 should not apply. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).
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> Respondent's [the Commissioner's] only argument

> is that petitioner presented no evidence and cited no authority which would explain the allocation of the legal fees between the net cash received and the premises. Petitioner contends that her allocation was not a negligent or intentional disregard of the rules or regulations, but a proper allocation based on her interpretation of the law. Respondent and petitioner agree, however, that the negligence addition should not be imposed where there is an honest difference between the parties with respect to a justifiable position.
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> Based on the facts before us, we find that petitioner should not be liable for the addition to tax. Little authority exists on which to base any solid legal position concerning the proper allocation of legal fees. Petitioner's position, while not upheld by this Court, is not so unjustifiable as to be subject to this addition to tax.

Balsamo, 54 T.C.M. (CCH) at 612-13.

Here, "Farnsworth" knew, before it filed any of the Illinois returns regarding the years at issue, that "Lubus's acquisition of "Pompano" was designed to enhance "Farnsworth's international business operations conducted inside and outside the water's edge of the United States. *See* 1996 Admin. Dec., pp. 4 ("The acquisition of "Pompano" allowed "Farnsworth" to sell its products directly or under license in over 40 countries, but principally in the United States, Denmark, Finland, Norway, Sweden, Holland, the Middle East, Nigeria, Malaysia Thailand and Indonesia. [citation omitted]"), 10 (referring to statements "Farnsworth" made in its Annual Reports following the 1983 acquisition of "Lubus" and "Pompano"). And "Farnsworth" did not need the Department to issue an administrative decision before it knew why it loaned money to "Lubus" in the first place, or the steps it took thereafter to refinance that debt. *See* 1996 Admin. Dec., pp. 5 (finding of fact #10), 11-12 ("Clearly, ["Farnsworth's] public offering [of stock] was nothing more than a sophisticated refinancing of the debt incurred in acquiring "Pompano"."). If it had taken into account those two facts when preparing its Illinois combined income tax

returns, “Farnsworth” could not have believed – in good faith - that the interest income it received from “Lubus” was in the nature of a passive investment (*see* National Realty & Investment Co., 144 Ill. App. 3d at 553, 494 N.E.2d at 932), or from a transaction that was wholly unrelated to the unitary business it conducted within the water’s edge.

“Farnsworth’s” arguments in this matter show that it knew that the Department had promulgated an administrative regulation in which it described the circumstances under which certain types of income should be reported as either business income or nonbusiness income. *See* Taxpayer’s Brief, pp. 2-3. Had “Farnsworth” truly made a good faith reading of income tax rule 3010 - that is, had “Farnsworth” read the *whole* rule or, at a minimum, had it read that part of the rule that actually pertained to income in the form of interest - subsection (d)(4) would have notified it that interest income should be classified as business income if the intangible with respect which the interest was received is held or created in the regular course of a taxpayer’s business, or if the reason for acquiring or holding the intangible is related to or attendant to the taxpayer’s business operations. 86 Ill. Admin. Code § 100.3010(d)(4). “Farnsworth” knew that both of those circumstances were true regarding its loan to “Lubus” for the acquisition of “Pompano”. *See* 1996 Admin. Dec., pp. 4-5, 10-12.

Finally, Illinois case law in effect before the tax years at issue had already recognized the presumption that income was to be reported as business income unless it was clearly classifiable as nonbusiness income. National Realty & Investment Co., 144 Ill. App. 3d at 553, 494 N.E.2d at 932. Nothing within the pertinent regulation presented “Farnsworth” with a good faith justification for believing that interest income received by a corporation as repayment for its loan to a wholly-owned subsidiary was clearly

classifiable as nonbusiness income. Nor has "Farnsworth" cited to any Illinois case law that would have provided it with such justification.

Conclusion:

After considering the facts and inferences reasonably drawn from the evidence and arguments in this matter, I conclude that "Farnsworth" has not shown that it acted with ordinary business care and prudence when attempting to determine and pay its Illinois income tax liabilities for 1989, 1990 and 1992.[2] Therefore, I conclude that taxpayer has not born its burden to show that the § 1005 penalties proposed for tax years 1989, 1990 and 1992 should be abated.

1/24/00
Date

Administrative Law Judge

[2] Neither "Farnsworth" nor the Department is bound by the determination regarding penalties for the earlier tax years, as it is fundamental to taxation that each tax year stands on its own. *See* Jackson Park Yacht Club v. Department of Local Government Affairs, 93 Ill. App. 3d 542, 546 (1st Dist. 1981).